19 August 2021

Outlook for Borrowers: Post-August MPS

- **The RBNZ kept the OCR at 0.25% at the August MPS but suggested it would have raised interest rates had it not been for the Covid-19 outbreak this week.**
- **Assuming this isn't a protracted lockdown, we expect the RBNZ to hike the OCR in the coming months and to eventually raise it to just over 2%, similar to the RBNZ's projections.**
- **Wholesale interest rates incorporate just over four OCR hikes by the end of 2022. Our central forecast sees the RBNZ raising the OCR faster and higher than the market. However, uncertainty is very high, not least due to the current lockdown.**
- **Global interest rates remain at very low levels. We see global rates heading higher over the coming year which should lead to higher NZ long-term wholesale rates.**
- **Fixed rate hedges offer certainty around interest payments in an environment where floating rates may soon be on the rise and there is uncertainty around how high the OCR needs to go.**

RBNZ Update

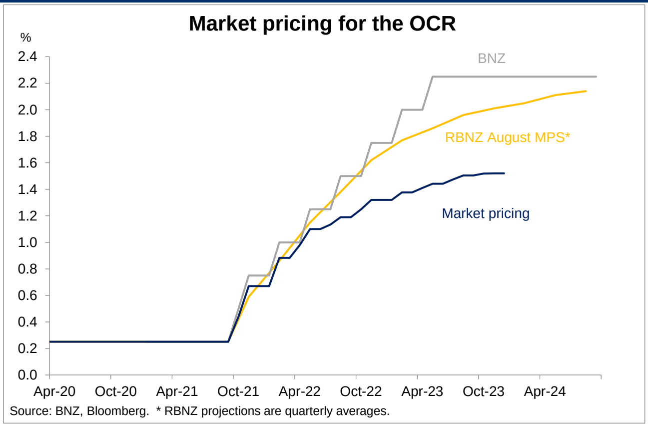
At the MPS this week, the RBNZ decided to keep the OCR on hold, at 0.25%. The RBNZ had been all set to raise the OCR for the first time since 2014, and its statement made it clear this was the plan. But news of a Covid-19 community case (the Delta variant) in the community and the government's subsequent decision to take the country straight into a Level 4 lockdown meant the RBNZ decided to keep the OCR on hold instead.

The RBNZ's assumption is that the current lockdown will be relatively short and leave few lasting scars on the economy (as has largely been the case with the previous lockdowns). If that's the case, the RBNZ will then likely revert to its original plan and start lifting the OCR. Its forecast OCR track suggests a reasonable chance of OCR hikes at each of the remaining two meetings this year.

The rationale for the RBNZ's guidance of future rate hikes is clear - it thinks it is meeting both its employment and inflation objectives. We agree. Core inflation is above 2%, and rising, while the unemployment rate is just 4%, amidst severe skills shortages. These are normally the circumstances in which the OCR would be closer to its 'neutral' level, not at emergency settings like it is now.

If this turns out to be a protracted lockdown, and it is clearly a risk given this is the Delta variant, then OCR hikes may be delayed further. Of course, it helps now that the vaccination roll-out is making good headway – meaning there should be light at the end of the tunnel – and the

Chart 1: The market prices a 70% chance of an October hike



Source: BNZ, Bloomberg. * RBNZ projections are quarterly averages.

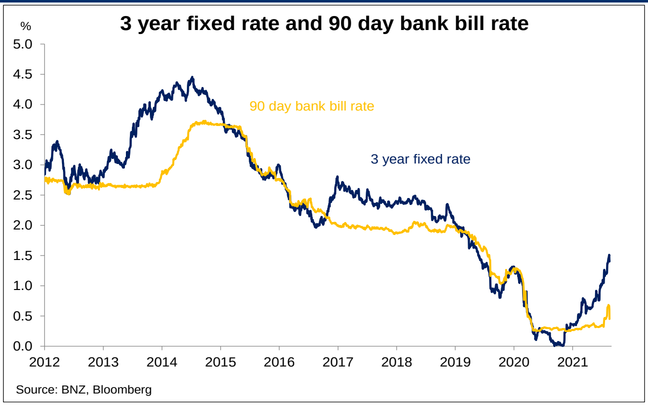
government has said it stands ready to provide fiscal support. We know from the original lockdown that the Wage Subsidy scheme was very effective in keeping people in jobs, despite the huge hit to the economy. But, OCR hikes could still be delayed until the lockdown is eased.

BNZ Economics expects rate hikes at the three upcoming meetings, in October, November and February, subject, of course, to the current Covid outbreak being brought under control before the next meeting. This is broadly in-line with market pricing and what the RBNZ indicated in its forecast OCR track at the MPS (see chart).

It is after this where views start to diverge. BNZ Economics have pencilled in a quarterly series of 25bp hikes from February, with the OCR reaching an anticipated 2.25% by mid-2023, slightly above the RBNZ's current estimate of the 'neutral OCR'. Market pricing, in contrast, starts to flatten off beyond mid-next year, with the OCR priced to reach around 1.30% by the end of 2022 and 1.50% by the end of 2023. The market doesn't price the OCR reaching 2% for six years' time.

We think the more gradual trajectory for market pricing reflects a few factors. First, there is the risk of a more extended lockdown, with less tightening required. Second, there is a widely held view that OCR hikes will 'bite' fast, given elevated levels of household debt, in turn implying the RBNZ won't need to lift the OCR very high to generate the required cooling effect on the economy. In this view of the world, the 'neutral' level of the OCR is lower than the RBNZ's 1.8% estimate. Third, market pricing for rate hikes by the Fed and the RBA is very restrained at present (around 125bps of tightening over the next five years). The market is often reluctant to price a radically different path for the OCR compared to these two central banks.

Chart 2: Short-term NZ rates at highest level since 2019



The debate around exactly how much tightening is required by the RBNZ is unlikely to be settled soon. It may turn out that, after three or four OCR hikes, the economy shows signs of slowing, the housing market could come under pressure, and the RBNZ could hit pause on its tightening cycle. Alternatively, if inflation (and the economy in general) is still powering along with borders reopening, then the market may start to see a 2% OCR, if not higher, as more realistic. Market pricing might be seen as some sort of average of these two scenarios.

BNZ Economics are more in the camp that the RBNZ will take the OCR to at least 2% given the considerable momentum in inflation, which doesn't look like it will subside any time soon. But they are also cognisant that there are enough risks out there to mean this isn't guaranteed. What happens globally, which will depend, in part, on the path of the virus, will be a major influence on how much tightening the RBNZ needs to do. We are still optimistic about the global recovery, notwithstanding the spread of the Delta variant.

Short-Dated Wholesale Fixed Rates (1-3 yr)

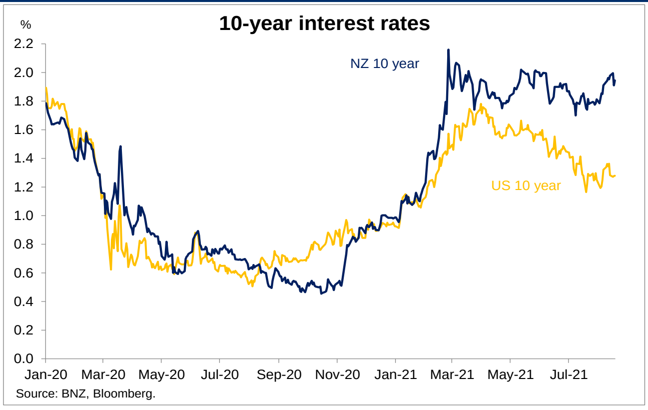
Short-term wholesale fixed rates have moved sharply higher over the past few months, even after this recent Covid-related pullback. Short-term rates are near their highest levels since mid-2019. These moves have occurred as the market has moved to price an earlier and larger series of OCR hikes over the next few years.

The 90-day bank bill rate dropped after the RBNZ decided to keep the OCR on hold. Assuming the RBNZ does raise the OCR over the coming months, the 90-day bank bill rate will start tracking higher.

The market expects short-term wholesale fixed rates to increase from here. For instance, the market prices the 2-year wholesale rate to increase by around 0.4% over the coming 12 months. Whether hedging is financially beneficial, compared to staying on floating, depends mainly on whether the RBNZ raises the OCR by more than what is already discounted.

Based on the BNZ Economics team's forecasts, which have the OCR reaching 2.25% in 2023, fixed rate hedges make sense. Clearly, there is a risk that the RBNZ doesn't end up raising the OCR this high, or rate hikes are significantly delayed by an extended lockdown. But, as a base case, we

Chart 3: US 10-year rate is well off its recent highs



don't think it's unreasonable to expect the OCR to be higher than 1.3% by the end of next year, which is what the market is pricing.

What fixed rate hedges offer is certainty around interest payments in an environment where floating rates may soon be on the rise and there is uncertainty around how high the OCR needs to go. Borrowers with greater exposure to interest rate risk may value this certainty.

Long-Dated Wholesale Fixed Rates (5-10 yr)

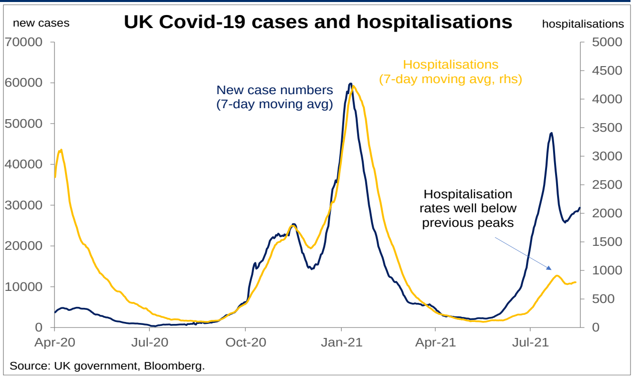
Since the last Outlook for Borrowers, long-term NZ wholesale rates have pushed a little higher, while global long-term interest rates have tracked sideways to lower.

The increase in NZ long-term rates relative to offshore markets over the past six weeks can be explained by the repricing of the RBNZ OCR outlook. But, over a long period of time, major trends in long-term NZ rates are driven by global movements, rather than changes in the near-term outlook for the OCR. This is because global trends usually define where the OCR will get to in the long run. We expect long-term NZ wholesale rates to be highly correlated to global rates going forward.

As a broad observation, global long-term interest rates remain extremely low by historical standards. The key US 10-year rate is below its pre-2020 all-time low and is around 50bps below the levels it reached in late-March.

Various explanations have been promoted for why long-term global rates have fallen over recent months. These include the spread of the Covid-19 Delta variant, which has swept through even those countries with high vaccination rates, such as the UK, and has led to renewed lockdowns in countries such as Australia and China (and New Zealand now!). One risk is that more cautious behaviour on the part of consumers, in response to health risks, could slow the global recovery, but the big risk is that a vaccine-resistant variant emerges, resulting in renewed lockdowns in major economies. For now, we think the evidence is tentatively encouraging that the vaccines are doing what they are supposed to do. Hospitalisation rates and deaths in the UK, which has removed almost all restrictions, are much lower than earlier this year with most hospital admissions coming from the unvaccinated. Covid variants and mutations remain a downside risk to the outlook.

Chart 4: UK hospitalisation rates well below previous peaks



Source: UK government, Bloomberg.

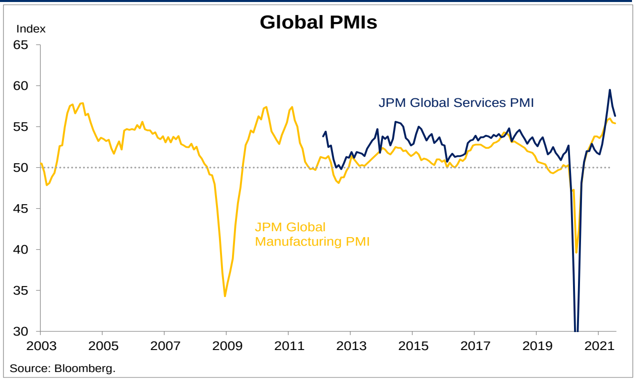
Other explanations include claims the global economy is moving past 'peak growth', as the impact of the huge US fiscal stimulus from earlier this year starts to fade. While it's true that some timely economic indicators, such as the PMIs, have come off their highs, they are still at levels consistent with very strong global growth. The reality is that, in countries like the US, the economy simply cannot maintain the almost 10% annualised growth rate it achieved in the second quarter. Global growth this year still looks on track to be its strongest in decades.

To us, the most persuasive (albeit not entirely satisfactory) explanation for the fall in global rates this year has been that investors have been caught offside. It had been popular to position for higher long-term interest rates earlier this year but, as rates first started to consolidate and then moved lower, some investors closed their positions out, generating additional downward momentum in interest rates. Over the past few weeks long-term global rates appear to have found a base.

Fundamentally, we think the medium-term risks are asymmetrically skewed towards higher global rates, a point we have been making for over a year. Economists and central bankers come in for plenty of flack when their forecasts of inflation and interest rates prove off the mark. The reality is that forecasting inflation is extremely hard at the best of times, let alone after a global pandemic.

There are scenarios where the global economy gets hit by new Covid variants and inflation falls back to low levels. In this case, global long-term interest rates will likely fall further although, given they are already extremely low, there is a limit to how far (last year, when the market thought the Federal Reserve would wait more than six years before raising its cash rate, the US 10-year rate hit 0.5%). Another scenario is that the current inflation pressures evident across the world prove more than just temporary and become embedded in wage and price setting behaviour, ultimately necessitating faster and larger central bank tightening cycles. In such a scenario, long-term global interest rates could increase substantially. The point is that there appears to be a larger-than-usual range of outcomes for inflation, but much more upside to long-term rates than downside if those risks materialise.

Chart 5: Global growth indicators still at very strong levels

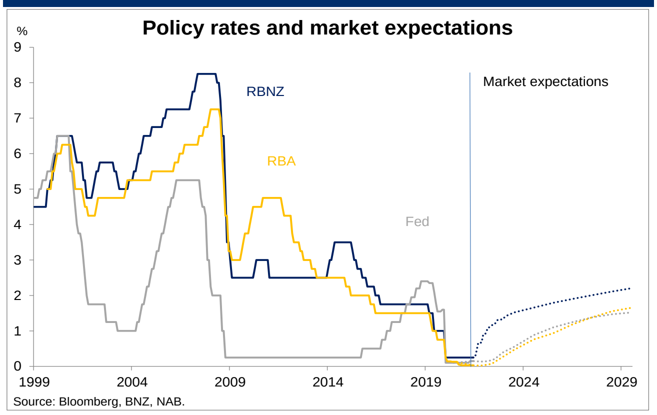


Source: Bloomberg.

As a base case, we expect global long-term rates to head higher over the coming year. The Federal Reserve is likely to start tapering its bond buying before the end of the year, which will set the clock ticking on when it will start raising interest rates. The latest Fed forecasts indicated most committee members saw rate hikes starting in 2023, although a sizeable minority was in favour of a 2022 start date, and that was before the last two employment reports, both of which showed almost 1 million new jobs created. In Australia, near-term economic activity will be depressed by the lockdowns across the country although vaccination is stepping up and history would suggest the economy will bounce back strongly once restrictions are removed. The RBA plans to taper its bond buying next month and, while it continues to suggest a 2024 start date to rate hikes is most likely, a plausible upside scenario would see an earlier commencement of rate hikes.

For NZ, we anticipate that higher global rates will flow through to long-term wholesale rates here, with OCR hikes an added tailwind. Risks to this view include the path of the virus, which could lead to a slower and lower path of OCR hikes, and high household debt, which might mean that less tightening is ultimately required than markets currently price. Long-term wholesale rates incorporate the OCR eventually reaching around 2% - 2.25% in 5-to-10-years' time, which some borrowers may be sceptical about but which is broadly in-line with where the BNZ Economics team and the RBNZ see the OCR getting to this cycle.

Chart 6: The OCR is priced to eventually get back above 2%



Source: Bloomberg, BNZ, NAB.

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